Effective Date: September 8, 1996

COORDINATED ISSUE
SHIPPING INDUSTRY
IRC SECTION 863(c)(2)SOURCE OF INCOME FROM TRANSPORTATION BETWEEN FOREIGN COUNTRY PORTS AND UNITED STATES' DEEP WATER PORTS

ISSUE:

Should the income generated from the transportation of crude oil from foreign countries to the Louisiana Offshore Oil Port ("LOOP"), be U.S. sourced in accordance with section 863(c)(2) of the Internal Revenue Code (the "Code")?

FACTS:

A substantial part of the oil imported into the United States is transported over long distances from the middle east and Africa in supertankers. While these supertankers are able to offload within the ports of other countries, they are too deeply drafted to enter the shallow U.S. ports and waters. This occurs because, unlike most other countries, the continental shelf area of the United States extends many miles beyond its shores and territorial waters.

In the early 1970s, five U.S. oil companies joined efforts to create deep water ports to solve this problem. As a result, the Deepwater Port Act of 1974, 33 U.S.C. § 1501 et seq. (the "Act"), was enacted in order to promote efficiency in transportation and to protect the environment by establishing procedures for the location, construction, and operation of Deepwater ports off the coasts of the United States beyond territorial waters.[1]

The only deep water port in operation today is the LOOP. It consists of a pipeline that

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[1] A Deepwater port is defined under 33 U.S.C.S. § 1502(10), as "any fixed or floating man-made structures other than a vessel, or any group of such structures, located beyond the territorial sea and off the coast of the United States and which are used or intended for use as a port or terminal for the loading or unloading and further handling of oil for transportation to any State... The term includes all associated components and equipment, including pipelines, pumping stations, service platforms, mooring buoys, and similar appurtenances to the extent they are located seaward of the high water mark."

extends from underground storage facilities on shore out along the ocean bed to the port which lifts its opening via one large buoy 19 miles off shore. Supertankers drop anchor at this port and moor to the buoy while transferring oil to the pipeline. These operations are subject to Coast Guard regulations. Using this method, crude oil can be unloaded in deep water beyond the United States territorial limits and transported by pipeline to on shore storage facilities.

LAW AND ANALYSIS:

Section 863(c)(2)(A) of the Code provides that 50 percent of all transportation income attributable to transportation which begins or ends in the United States shall be treated as from sources within the United States. The provision applies equally to United States and foreign persons.

Section 863(c)(3) of the Code defines, in pertinent part, the term "transportation income" as "any income derived from, or in connection with... the use (or hiring or leasing for use) of a vessel." This term includes income from the carriage of crude oil on a vessel, and income from the charter of a vessel used by the charterer to carry crude oil for hire.

Section 7701(a) of the Code provides that when a term is used in the Code where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term "United States" when used in a geographical sense includes "only the States and the District of Columbia." Section 7701(a)(9). Under section 7701(a)(10), the term "State" is to be construed to include the District of Columbia, where that construction is necessary to carry out the provisions of the Code.

The Act, 33 U.S.C. § 1518(a) provides in pertinent part that:

> The Constitution, laws, and treaties of the United States shall apply to a Deepwater port licensed under this Act [2] and to activities connected, associated, or potentially interfering with the use or operation of any such port, in the same manner as if such port were an area of exclusive Federal jurisdiction located within a State.[3]

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[2] However, the Act, 33 U.S.C.S. 1518(d), generally excludes the application of the U.S. customs laws to the LOOP.

[3] The Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C.S. § 1333(a), which section 638 effectively brought into Chapter 1 of the Code, served as the model for the Deepwater Port Act. The OCSLA provides:

(continued...)

Thus, the Act provides that the Constitution and laws and treaties of the United States apply to a deep water port in the same manner as if such port were "an area of exclusive Federal jurisdiction located within a State." The unambiguous sweeping language of the Act ("[t]he Constitution, laws, and treaties of the United States") necessarily includes federal income tax laws among the laws of the United States applicable to the LOOP.[4]

Consequently, for purposes of section 863(c)(2), the LOOP is deemed located within a State, so transportation that ends at the LOOP is deemed to end in the United States and 50 percent of the resulting income must be treated as from sources within the United States.

INCOME TAX CONSEQUENCES OF U.S. SOURCED TRANSPORTATION INCOME:

Foreign corporations engaged in international shipping activities may be eligible for exemptions from U.S. taxation through an income tax treaty between their country of residence and the United States. In general, these exemptions are found in treaties in Article 8, Shipping and Air Transport. In addition to treaties, section 883 of the Code also provides and exemption for foreign corporations engaged in international operation of ships.

Under section 883, when such a corporation is organized in a foreign country that provides an equivalent exemption to corporations organized in the United States for income derived from the international operation of ships and that corporation also

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> The Constitution and laws and civil and political jurisdiction of the United States are hereby extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands, and all installations and other devices permanently or temporarily attached to the seabed, which may be erected thereon for the purpose of exploring for, developing or producing resources therefrom, or any such installation or other device (other than a ship or vessel) for the purpose of transporting such resources, to the same extent as if the outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State...

OCSLA remains authority for construing the "United States" to include the Continental Shelf for purposes of non-chapter 1 Federal taxes. E.g., Rev. Rul. 86-108, 1986-2 C.B. 175; Rev. Rul. 83-143, 1983-2 C.B. 196; Rev. Rul. 81-257, 1981-2 C.B. 214; Rev. Rul. 77-197, 1977-1 C.B. 344.

[4] This is implicitly confirmed by section 1518(d), noted above, which only excludes the application of U.S. customs laws to the LOOP.

meets the ownership requirements of section 883(c), its income is not included in gross income and is exempt from U.S. income taxation. The foreign country may provide an equivalent exemption through its domestic law or through an exchange of diplomatic notes with the United States evidencing such an exemption.[5] Consequently a large number of foreign taxpayers will be eligible for an exemption and will not pay U.S. tax on their U.S. source transportation income.

However, foreign taxpayers not qualifying for a section 883 exemption or for benefits under an income tax treaty will be subject to a four percent tax on their "U.S. source gross transportation income" under section 887 of the Code. If a foreign corporation is engaged in a trade or business in the United States and has income which is effectively connected with that trade or business, within the meaning of the special rules under section 887(b)(4), it must file a federal income tax return and pay tax on the basis of its net income under section 882, in lieu of paying the gross basis tax. Such effectively connected income could also be subject to the branch profits tax under section 884.

CONCLUSION:

The LOOP is within the United States for purposes of the Internal Revenue Code. Therefore, the transportation of crude oil ends in the United States when the cargo is offloaded at the LOOP. Accordingly, 50 percent of all transportation income attributable to transportation of crude oil which ends at the LOOP shall be treated as from sources within the United States for purposes of section 863(c)(2) of the Code.

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[5] Rev. Rul. 89-42, 1989-1 C.B. 234, includes a table of countries that provide such an exemption. This revenue ruling will be modified periodically to update the information in the table.